

November 15, 2004

**Via Electronic Delivery**

Federal Trade Commission  
Office of the Secretary  
Room 159 (Annex W)  
600 Pennsylvania Avenue, NW  
Washington, D.C. 20580

**RE: Franchise Rule Staff Report, R411003**

Dear Secretary Clark:

The Washington State Securities Division appreciates the opportunity to comment on the Federal Trade Commission's Franchise Rule Staff Report (the "Staff Report") on the FTC's Trade Regulation Rule on Disclosure Requirements and Prohibitions concerning Franchising, 16 C.F.R. Part 436 (the "Franchise Rule").

The Securities Division regulates the offer and sale of franchises and business opportunities in the State of Washington under statutory schemes, RCW 19.100 and RCW 19.110, that require the offer and sale of franchises and business opportunities to be registered with the Division, unless the transactions are otherwise exempt. Most franchises and business opportunities registered with the Division fall within the definition of "franchise" under the Franchise Rule. The Division reviews the disclosure documents of sellers and conducts administrative investigations of violations in the offer and sale of franchises and business opportunities in the state. The Division has had the pleasure of working with the Commission's staff over the years in the investigation of fraudulent franchise and business sellers and participated in enforcement sweeps organized by the Commission's staff. The Division is also a member of the North American Securities Administrators Association (NASAA), the oldest international organization devoted to investor protection. NASAA and its members have also been engaged in cooperative enforcement projects, information sharing, and training opportunities with the Commission's staff in the franchise area.

We commend the Commission and its staff for its efforts to improve and enhance investor protection through disclosure based on the Uniform Franchise Offering Circular Format that has been the franchise registration states' standard for nearly thirty years. We agree with the Commission's staff that the additional disclosures suggested in the Staff Report would benefit prospective franchisees. We also agree that some disclosures currently required in the UFOC Guidelines can be stated more clearly, and we concur with many of the clarifications that Commission staff proposed. In most cases, these additional disclosures and clarifications further our shared goal of ensuring that prospective franchisees receive meaningful disclosure about a franchise offering.

## Specific Comments to Proposed Franchise Disclosure Document

### A. Cover Page Proposed Section 436.3

#### 1. Reference to Items 5 and 7 Fees.

In the Staff Report, the FTC staff recommended that the Commission adopt the following language for the Cover Page of the franchise disclosure document:

The total investment necessary to begin operation of a [franchise system name] franchise is [the total amount of Item 7], including the [total amount in item 5] that must be paid to the franchisor.

We recommend that the Commission add the phrase **and any affiliates** at the end of this sentence. Proposed Item 5 of the Staff Report requires disclosure of all “initial fees.” Initial fees are defined in the Staff Report to include “fees and payments received from the franchisor or any affiliate before the franchisee’s business opens.” This definition of initial fees is an improvement from Item 5 of the UFOC Guidelines, which does not state specifically that a franchisor must disclose fees payable to a franchisor’s affiliates as well as the franchisor.<sup>1</sup>

We recommend that, for consistency, the FTC should amend the above disclosure to clarify that, on the cover page, the franchisor must disclose amounts to be paid to the franchisor and any affiliates. The addition of the phrase “and any affiliates” will make clear that the franchisor must disclose all “initial fees,” in both Item 5 and on the Cover page, under the same definition.

#### 2. Risk Factors

We appreciate the staff’s sensitivity to the states’ authority to impose additional risk factors, in appropriate circumstances, on the cover page of the franchise disclosure document. We request, however, that the Commission clarify its position regarding the practical implications of allowing additional disclosures, such as risk factors that states may require. That is, the language quoted above may be construed to prohibit states that review franchise disclosure documents from requiring franchisors to amend the disclosure document itself.

In some cases, states that review franchise disclosure documents may require non-exempt

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<sup>1</sup>A Commentary on the UFOC Guidelines issued by NASAA in 1994 states, however, that “Initial fees” includes all fee and payments required by the franchisor and its affiliates before the franchisee’s business opens. *See* NASAA Commentary to the Uniform Franchise Offering Circular Guidelines (1999) Bus. Franchise Guide (CCH) (hereafter “NASAA Commentary”) ¶5790 at 8469.

additional state disclosures by a separate addendum, but in other cases, states may require additional disclosures and clarifications to the franchise disclosure document itself. For example, if a state requires a franchisor to make a specific risk factor on the franchisor's cover page, that risk factor should be made on the cover page of the disclosure document, not on a *separate* cover page that is part of an addendum to the disclosure document.

Therefore, we request that the FTC clarify, perhaps in compliance guides that accompany the final Franchise Rule, that states may require non-exempt additional state disclosures, including state specific risk factors, in the franchise disclosure itself, and that there should be only *one* cover page to the document that includes both federal and non-exempt state disclosures.

**B. Item 2: Business Experience**

The Staff Report acknowledges the importance of identifying all individuals who control the franchisor, regardless of formal title and recommends disclosure for individuals who occupy a status similar to a principal officer, director, trustee, or general partner. We request that the disclosure of an individual or entity owning a majority interest in the franchisor be disclosed as that person, by virtue of his or her ownership, exerts significant control over the franchisor even if it is not on a day to day basis.

**C. Item 8: Restrictions on Sources of Products and Services  
Proposed Section 436.5(h)**

With respect to Item 8 of the proposed Franchise Rule, on page 22 of Attachment B, we recommend that the Commission move footnote 5 from its current position to the end of Section 436.5 (h)[Item 8](6)(i). This suggestion is made purely for the sake of clarity.

Footnote 5 on page 22, relating to the "precise basis" disclosure of Item 8, states that figures for this disclosure should be taken from "the franchisor's most recent annual audited financial statement... ." However, from the list of figures comprising the precise basis disclosure in Section 436.5(h)(6), only the very first figure listed at Section 436.5(h)(6)(i), "total revenue," is required to be listed in an audited financial statement. The other figures, listed in Section 436.5(h)(6)(ii), (iii), and (iv), are not generally found in a franchisor's annual audited financial statement.

**D. Item 15: Obligations to Participate in the Actual Operation of the Franchise Business  
Proposed Section 436.5 (o)**

In the NPR, the Commission staff stated that the text of proposed Item 15 was intended to be identical to Item 15 of the UFOC Guidelines. The Staff Report reflected that staff intended Item 15 under the proposed Franchise Rule to be identical to UFOC Item 15. As currently drafted, however, Item 15 in the Staff Report requires less disclosure than the comparable disclosure under the UFOC Guideline. Specifically, in the reorganization of the text, proposed

Item 15 limits the disclosures regarding whom a franchisee may hire as an on-premises supervisor, and that person's required successful completion of training, to franchisees who are individuals but not franchisees who are business entities. Based on the staff's discussion of the revision of this item, this omission appears to be inadvertent.

In addition, we recommend that the final Franchise Rule should clarify that Item 15 requires disclosure of all agreements regarding the franchise that apply to the franchisee's owners. The NASAA Commentary discusses that UFOC Item 15 requires this disclosure. See NASAA Commentary, ¶5790 at p. 8479-3. There is no comparable provision in the Staff Report regarding this disclosure.

**E. Item 19: Financial Performance Representations  
Proposed Section 436.5(s)**

In Item 19 of the proposed Franchise Rule disclosure, the Commission staff suggests that if a franchisor furnishes financial performance information according to [Item 19], the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document.

We suggest that the Commission clarify, at least in compliance guides that will accompany the final Franchise Rule, what is meant by a "variation" on a financial performance representation. Specifically, we are concerned that this language not be construed so broadly as to allow franchisors making an Item 19 disclosure to make a supplemental disclosure of a "variation" that does not relate to the underlying Item 19 disclosure.

**F. Item 20: Outlets and Franchisee Information  
Proposed Section 436.5(t)**

We applaud the staff for accepting NASAA's suggestion to revise Item 20. We remain concerned, however, about the impact that confidentiality clauses (or "gag clauses," as they were called in the NPR) may have on a prospective franchisee's ability to obtain meaningful information about a franchise system from perhaps the most useful sources, existing and terminated franchisees.

In light of the continued prevalence of confidentiality clauses in franchising, the fact that these clauses are antithetical to the most basic tenets of franchise disclosure, and the fact that the effect of these confidentiality clauses will not be limited under the proposed Franchise Rule, we suggest that on page 57 of Attachment B, the proposed disclosure that currently reads:

Franchisors may also disclose the number and percentage of current and former franchisees who during each of the last three years, signed agreements that included confidentiality clauses and may disclose the circumstances under which such clauses were signed,

be revised to

Franchisors **must** also disclose the number and percentage of current and former franchisees who during each of the last three years, signed agreements that included confidentiality clauses and must disclose the circumstances under which such clauses were signed (Emphasis supplied).

**G. Item 21: Financial Statements  
Proposed Section 436.5(u)**

**1. U.S. GAAP**

In proposed Item 21 of the Staff Report, the Staff recommends that franchisors be required to include financial statements “prepared according to United States generally accepted accounting principles, or as permitted by the Securities and Exchange Commission, or as revised by any future government mandated accounting principles.”

We are concerned that the phrase “or as permitted by the Securities and Exchange Commission” may create uncertainties. At present, the Securities and Exchange Commission (“SEC”) allows financial statements prepared by certain foreign public companies using non-U.S. GAAP to reconcile those statements to U.S. GAAP. The Staff Report appears to contemplate that franchisors, whether or not public companies, be allowed to reconcile foreign financial statements to U.S. GAAP, to the extent permitted by the SEC for public companies. The SEC rules allowing reconciliations for foreign statements in this circumstance are part of a comprehensive regulatory scheme that does not apply to franchisors, unless they are public companies.

We agree that franchisors should be allowed to utilize foreign financial statements that are reconciled to U.S. GAAP. The reference “as permitted by the SEC,” however, is confusing and, if retained, should be clarified.

In addition, we suggest that the first sentence of proposed Item 21, Section (1) be revised to clarify that the requirement for U.S. GAAP statements applies to all financial statements, not just the financial statements discussed in Section (1) of Item 21.<sup>2</sup>

**2. Future Government Mandated Accounting Principles**

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<sup>2</sup>As currently written, proposed Item 21, Section (1) states “Include the following financial statements prepared according to United States [GAAP].” The word “following” may be confusing as it could be construed to apply only to the four subsections following Section (1), rather than to both Section 1 and Section 2 of Item 21. The disclosure could be clarified by conforming to Item 21 of the UFOC Guidelines, which begin by stating “Prepare financial statements according to GAAP [United States GAAP].”

We are concerned that the phrase “or as revised by any future government mandated accounting principles” may need clarification. The Staff Report reflects that this phrase was added because the staff recognizes the possibility that American accounting principles are likely to change. The above phrase, however, does not relate to American accounting principles. The term “government” is broad and can relate to any government, not just the U.S. government. At a minimum, therefore, the phrase should be revised to discuss future U.S. government mandated accounting principles.

### **3. GAAS**

Proposed Item 21 in the Staff Report states that “financial statements must be audited by an independent certified public accountant using generally accepted auditing principles.” We recommend that this revision be revised to refer to generally accepted United States auditing standards, rather than principles. This terminology is used in the Staff Advisory Opinion 02-4, quoting the Statement of Basis and Purpose accompanying the current Franchise Rule, 43 Fed. Reg. 59,614, 59,680 n. 433 (December 21, 1978), and is the correct terminology used in the accounting profession and the financial community.

### **4. Updates**

The UFOC Guidelines requires specifically that unaudited financial statements prepared in accordance with GAAP be included in the franchise disclosure document if the audited financial statements precede the application date by more than 90 days. In the Staff Report, the only financial statements required are audited financial statements as of the date of the franchisor’s fiscal year end. The Staff Report would require franchisors to revise the disclosure document within 120 days of the end of its fiscal year, to prepare revisions each quarter to reflect any material changes, and to include its 1<sup>st</sup> quarterly update in its annual report. It does not specifically require franchisors to update financial statements, except when the franchisor deems the financial statements reflect a material change.

Because a franchisor’s financial condition is so critical to the investment decision of prospective franchisees, we recommend that the final Franchise Rule be revised so that franchisors are required to provide updated financial statements based on the same criteria currently required under the UFOC Guidelines.

### **5. Phase- In of Financial Statements**

We request that the staff provide specific examples of which financial statements are required in specific circumstances. As currently drafted, the disclosure is not clear as to whether the unaudited opening balance sheet is the only required financial statement to be included in the first partial or full fiscal year the franchisor is in the business of offering and selling franchises. *Compare* Item 21(2)(i) with Item 21(2)(iv)(C).

## **6. Flexibility in Amending Financial Statements in the UFOC**

We and other franchise registration states are considering adopting a proposal for a system in which franchisors annual registration periods and filings would be spread evenly throughout the year rather than concentrated near the spring when most franchisors are receiving their previous year's annual audited statements. This would facilitate more timely and thorough review of franchise disclosures in the registration states. In order to accomplish this, the states would permit franchisors to supplement their offering circulars by inserting the updated audited financial statement at Item 21, without the need to file an amendment to the state registration.

Since 1980, the FTC has permitted franchise registration states to determine the timing of the annual updates for franchise offering circulars used in their states, as set forth in the FTC staff opinion to the Virginia Division of Securities and Retail Franchising issued on June 28, 1980. We are not aware of any problem related to use of franchise offering circulars that are updated on a 12-month cycle not based on the franchisor's fiscal year-end. We believe that coordination between franchise registration states and the FTC is crucial for the success of proposal, we believe that it is essential that the FTC, either in the revised rule or in the compliance guidelines that will accompany the revised rule, permit franchisors to annually update their franchise offering circulars if on a different time frame than the 120 days after fiscal year-end period currently contemplated by revised rule section 436.7(a), but without burdening the franchisor with two separate updates: one to conform to the state-assigned renewal date and the other to comply with the revised rule's 120-day time frame. One option would be to permit the franchisor to substitute an ending date designated by the state for certain fiscal year-end information required by the revised rule. Another option is to permit a franchisor to attach newly issued audited fiscal year-end financial statements to an existing state-registered franchise offering circular without the need to update the remainder of the offering circular (except for other material changes, if any).

We believe the proposed change will relieve franchisors from any added burdens and expense of complying with both FTC and state disclosure requirements, will make the registration renewal process more efficient for both the franchise registration states and franchisors, and will not diminish the value or usefulness of the franchise disclosure document received by prospective franchisees. For these reasons, we urge the FTC to ensure that the revised rule is flexible enough to accommodate a state-assigned registration renewal date without adding additional compliance burdens on franchisors.

## **Conclusion**

We offer to work with the Commission staff to finalize a Franchise Rule. We

appreciate the opportunity to comment on the Staff Report. Should you have any questions, please feel free to contact Martin Cordell at 360-902-8772.

Very Truly Yours,

A handwritten signature in black ink that reads "Michael E. Stevenson". The signature is written in a cursive style with a large, looped initial "M".

Michael E. Stevenson  
Securities Administrator